



DELAINE EASTIN
State Superintendent of Public Instruction

**CALIFORNIA
DEPARTMENT
OF
EDUCATION**

721 Capitol Mall

P. O. Box 944272

Sacramento, CA

94244-2720

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To: County and District Superintendents
County and District Chief Business Officials
Charter School Administrators

From: Janet Sterling, Director
School Fiscal Services Division

Subject: GASB 34 Implementation Issues

This letter is the second in a series of correspondence regarding the new financial reporting requirements of Governmental Accounting Standards Board (GASB) Statement 34, *Basic Financial Statements – and Management’s Discussion and Analysis – For State and Local Governments*. In our letter dated November 15, 1999, we provided an overview of GASB 34, discussed some of the implications for local educational agencies (LEAs), and promised to notify you of GASB 34 implementation issues as we identify them.

While we recognize there will be a significant workload associated with implementing GASB 34, we believe California’s LEAs must comply with the provisions of this new national standard. In an effort to provide guidance and assist LEAs in implementing the Statement, the California Department of Education (CDE) has formed an advisory committee to explore implementation issues. The advisory committee is comprised of representatives from various agencies and groups that have expertise in or will be impacted by the changes in school district and county office financial statements. In this letter, we will discuss implementation issues the advisory committee has identified to date, and alert you to what we believe should be every LEA’s initial priorities.

We have also dedicated a portion of our Web site (www.cde.ca.gov/sfsdiv) to GASB 34 issues. This site has our correspondence regarding GASB 34, a tentative schedule of GASB 34 effective dates for LEAs, and links to related information and resources. We will also post training opportunities and answers to frequently asked questions.

As the first step toward a full understanding of GASB 34’s implications for LEAs, we recommend that you review the statement in its entirety. You can obtain the statement directly from GASB’s Web site (www.gasb.org).

BENEFITS TO LEAS OF IMPLEMENTING GASB 34

The primary objective of GASB 34 as defined in the Introduction to the Statement is “to enhance the understandability and usefulness of the general purpose external financial reports . . . to the citizenry, legislative and oversight bodies, and investors and creditors.” However, we believe there are a number of additional benefits:

- ◆ Management Discussion and Analysis (MD&A). This narrative, prepared by management, provides an opportunity for management to give its perspective on events affecting the financial statements. Examples include short-term and long-term analyses of the agency’s activities, reasons for significant changes from the prior year, and economic factors that affected operating results. The MD&A is similar to corporate annual reports with which many people are familiar.
- ◆ Fund-Based Statements. The Governmental Accounting Standards Board acknowledges the value of fund-based statements in measuring, in the short term, the operating results of certain activities and in assessing compliance with budgets and other legal or contractual requirements. Consequently, little of LEAs’ existing budgetary and accounting activities will change. LEAs will continue to utilize a fund-based approach in planning and budgeting. They will continue to prepare fund-based financial statements using the current financial resources measurement focus and the modified accrual basis of accounting for governmental funds.
- ◆ Government-wide Statements. The government-wide statements are prepared on the full accrual basis, more in line with commercial accounting and more familiar and meaningful to the public. They illustrate, as the fund-based statements do not, all of the agency’s major activities by function, regardless of fund. They also identify the net cost of providing governmental services, an important component of accountability.

The government-wide statements include depreciation of exhaustible capital assets such as buildings and equipment. They illustrate the matching principle, showing how assets are used over time.

Incidentally, the standardized account code structure (SACS) objectives of reducing the administrative burden on LEAs in preparing required financial reports, and providing better information for use by administrators, parents, board members, legislators and others interested in school finance, are well met with regard to GASB 34. SACS will allow LEAs to prepare the new government-wide statements by function. Without SACS, preparing these statements would be difficult at best.

- ◆ Budget Comparison. The new budget comparison includes the adopted budget, the final budget, and actual revenues and expenditures. This new comparison presents an opportunity to highlight and explain the changing financial environment in which LEAs operate and the valid reasons for differences between the adopted and final budgets.

Overall, we believe GASB 34 presents an excellent opportunity to provide further training to school boards and district administrators on sound financial, budgetary, and analytical practices.

CAPITALIZATION THRESHOLD AND CAPITAL ASSET INVENTORY

The initial priorities for each LEA are to determine an appropriate capitalization threshold and begin identifying and valuating capital assets. Although the implementation schedule requires the first LEAs to implement GASB 34 in 2001-02, we encourage all LEAs to begin these steps now.

With the advent of GASB 34, LEAs' capitalization thresholds have taken on greater significance than in the past. In exploring implementation issues, the CDE has considered information from a variety of sources and is revising its past guidance on this topic. We will propose revisions to the next edition of the California School Accounting Manual (CSAM) to reflect the revised guidance.

Capitalization Threshold

A capitalization threshold is the monetary part of the criteria by which an organization determines whether an asset should be reported on the balance sheet. The criteria also include the item's estimated useful life. Capitalization thresholds may differ from one organization to another depending on materiality; typically, the larger the organization, the higher its capitalization threshold.

Guidance on capitalization includes the following:

- ◆ *Governmental Accounting, Auditing and Financial Reporting* (Government Finance Officers Association, 1994) describes the latitude in determining a capitalization threshold:

There is no uniform rule governing when a given asset should be capitalized. Rather, each government is responsible for establishing a capitalization policy appropriate to its specific circumstances Typically, a government's capitalization threshold correlates with its size.

In recent years, more and more governments have come to re-examine their capitalization thresholds. Often cost/benefit considerations lead governments to conclude that a higher capitalization threshold may be appropriate in their circumstance.

- ◆ The Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments, Attachment B*, touches on capitalization in its guidelines for administration of federal grants. It allows property costing up to \$5,000 to be charged to federal grants as supplies, rather than capital outlay, unless the recipient organization has a lower capitalization threshold:

19(a)(2): "Equipment" means an article of nonexpendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals the lesser of (a) the

capitalization level established by the governmental unit for financial statement purposes, or (b) \$5,000.

[And]

19(h): Items of equipment with an acquisition cost of less than \$5,000 are considered to be supplies and are allowable as direct costs of Federal awards without specific awarding agency approval.

- ♦ The *State Accounting Manual* used by California state agencies (not to be confused with the *California School Accounting Manual (CSAM)* used by LEAs) requires capitalization of property for accounting purposes when the property has a normal life of at least one year and a unit acquisition cost of at least \$5,000. Nothing costing under \$5,000 is capitalized; anything costing over \$5,000 is.

Inventory vs. Capitalization

Property inventory requirements and capitalization thresholds are different subjects that are commonly confused because of their overlapping terminology.

An inventory is an itemized list for tracking and controlling property.

Capitalization is an accounting treatment whereby an item is recorded as an asset on the balance sheet rather than as an expense of the current period.

Capital assets are those assets that meet the estimated useful life and monetary cost criteria and warrant capitalization in the financial statements. All items owned by an organization can rightfully be considered assets, but as a practical matter, organizations do not capitalize all of them.

Education Code Section 35168 requires LEAs to maintain an inventory of items costing more than \$500. Many, including the CDE in the past, have interpreted this section to mean LEAs must capitalize items costing more than \$500. In the CDE's exploration of implementation issues associated with GASB 34, the significance of the distinction between inventory and capitalization has become more apparent.

While all capitalized items should be inventoried, not all inventoried items should necessarily be capitalized. Organizations typically maintain inventories, for accountability and internal control purposes, of many items of property they do not capitalize on their financial statements. For example, LEAs might inventory VCRs and computers for internal control purposes, but not capitalize them due to their low cost.

Establishing a Capitalization Threshold

In establishing capitalization thresholds, LEAs should consider the following:

Financial Reporting issues. Materiality to the financial statements should be the principal concern in determining a capitalization threshold. In its *Recommended*

Practice - Establishing Appropriate Capitalization Thresholds for Fixed Assets (1997), the Government Finance Officers Association states:

Capitalization is, of its nature, primarily a financial reporting issue. That is to say, a government's principal concern in establishing specific capitalization thresholds ought to be the anticipated information needs of the users of the government's external financial reports. While it is essential to maintain control over all of a government's fixed assets, there exist much more efficient means than capitalization for accomplishing this objective in the case of a government's smaller fixed assets. Furthermore, practice has demonstrated that fixed asset systems that attempt to incorporate data on numerous smaller fixed assets are often costly and difficult to maintain and operate

As a general rule, capitalization thresholds should be designed to encompass approximately 80 percent of a government's total noninfrastructure assets

In no case should a government establish a capitalization threshold of less than \$1,000 for any individual item.

Depreciation of capital assets under GASB 34. Depreciation represents the recognition of the cost of an asset over time, by calculating its estimated loss in value during each accounting period. The new financial reporting model requires LEAs to calculate and report depreciation on their capital assets.

The higher the LEA's threshold for capitalization of capital assets, the fewer items of property for which the LEA must calculate depreciation. By establishing an appropriate capitalization threshold, LEAs can significantly reduce the number of individual items they must depreciate without significantly reducing the total dollar value of their capitalized assets.

Internal control issues. A system of strong internal controls over assets is essential to minimize the risk of loss or misuse. An inventory of property is a fundamental tool of internal control. As mentioned, organizations may require inventories, for accountability and internal control purposes, of many items that they do not capitalize.

The CDE emphasizes that LEAs should continue to maintain rigorous accountability for their property whether it is capitalized or not. We noted earlier that the State of California's threshold for capitalization of state property includes a unit acquisition cost of at least \$5,000. But for accountability and control purposes, the State requires that all state property, capitalized or not, be tagged and inventoried. The *State Accounting Manual*, Section 8603, states that "Acquisitions of noncapitalized property are . . . recorded in the property register and accounted for as expenditures."

When LEAs establish capitalization thresholds different from their inventory thresholds, they can still reconcile their inventories to their accounting records. They can

distinguish their noncapitalized, but inventoried, property charged to Object 4300, Materials and Supplies, from other materials and supplies charged to that account by creating a locally-defined Noncapitalized Property account in the 4300 series.

While *Education Code* Section 35168 requires that LEAs inventory items costing more than \$500, it does not preclude LEAs from inventorying items costing less.

CDE's Recommendation

The CDE recommends, for most LEAs, a capitalization threshold that includes a unit acquisition cost criterion of at least \$5,000. For larger LEAs, the appropriate capitalization threshold may be higher. LEAs should carefully examine their capitalization thresholds and determine a materiality level that is appropriate for their individual organization. LEAs may also wish to discuss this matter with their auditors.

Establishing a Capital Asset Inventory

Establishing a capital asset inventory can easily take a year, but LEAs may encounter issues that make the process even longer. As examples, some LEAs may need to establish title to their land; they may discover that title was never granted in the district's name, perhaps due to a past reorganization. Some LEAs may hold parcels in joint tenancy with other governmental agencies, which will require resolution as to how the parcel should be reported in the financial statements. Some LEAs may own facilities on land to which another agency holds title. And some LEAs that participated in the Leroy Greene Lease-Purchase program may find that the State of California retains title.

Generally accepted accounting principles (GAAP) require the use of historical cost for valuation of capital assets. Historical cost means the actual cost at the time of acquisition, including any additional sales tax, freight, or installation charges. There are accepted methodologies for estimating historical cost if it is not readily available. These include the use of historical sources, such as vendor catalogs, to establish the cost of the same or a similar asset at the time of acquisition; and backtrending, in which the current cost of a similar asset is divided by the appropriate price index to arrive at the historical cost.

DEPRECIATION ISSUES

GASB 34 allows agencies to use any established depreciation method. The CDE recommends that LEAs use the straight-line method, with or without salvage value, as this is the simplest and most straightforward depreciation method.

Regardless of the depreciation method used, LEAs will need to determine estimated useful lives for their capitalized assets, that is, the number of years over which assets will be depreciated. The Association of School Business Officials (ASBO) is preparing an implementation guide for school districts on GASB 34 which is due for release within the next few months and which is expected to include recommendations for estimated useful lives of common assets. We will post these guidelines on our web site when they become available.

LEAs will also need to assess the degree to which their financial accounting systems can be used in calculating depreciation. While most systems have capital assets inventory modules, they may not include depreciation calculations. LEAs may need to use a separate application, such as a spreadsheet program, to calculate depreciation.

EFFECTIVE DATES

GASB 34 becomes effective in three phases based on LEAs' total annual revenues. The largest LEAs must apply the statement for the 2001-02 fiscal year, the next largest LEAs for the 2002-03 fiscal year, and all remaining LEAs for the 2003-04 fiscal year. A preliminary list of effective dates, based on LEAs' 1998-99 unaudited actual revenues for all funds excluding other financing sources and transfers in, is attached.

FUTURE CDE EFFORTS REGARDING GASB 34

We will continue meeting with the GASB 34 advisory committee to identify implementation issues and will continue to communicate these issues as they are identified. For now, we encourage LEAs to determine an appropriate capitalization threshold and begin the identification and valuation of capital assets.

We will propose revisions to the *CSAM* over the next several years to provide guidance on issues relating to GASB 34, and will modify the state financial reporting software to assist LEAs in adapting their fund-based financial data for the new full-accrual government-wide statements.

It is recognized that training will be essential to make GASB 34 implementation successful and meaningful. Our plan is to provide training this fall and we will post training dates and opportunities on the Web site as they become available. As a prerequisite for training, we again recommend you read the GASB 34 statement

If you have questions or if we can be of further assistance, please contact the Office of Financial Accountability and Information Services by telephone at (916) 322-1770 or by e-mail at (faisinfo@cde.ca.gov). Please note that this letter and our November 15 letter are available on the CDE Web site (<http://www.cde.ca.gov/sfsdiv/financial/financial.htm>) under Fiscal Management Advisories, Bulletins, and Correspondence.

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Attachments

***Implementation Schedule: Summary count of LEAs by county**

***Implementation Schedule: Detailed list of LEAs by county**